United States Court of Appeals

for the Second Circuit

REPLY BRIEF

76-4232

United States Court of Appeals

For the Second Circuit

WILLIAM M. IVLER and BARBARA IVLER,
Plaintiffs-Appellants

against

COMMISSIONER OF INTERNAL REVENUE,
Defendant-Appellee

On Appeal from the United States Tax Court

REPLY BRIEF FOR THE APPELLANTS

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No. 76-4232

WILLIAM M. IVLER and BARBARA IVLER,

Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

ON APPEAL FROM THE UNITED STATES TAX COURT

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PRELIMINARY STATEMENT

In its brief on appeal, appellee Commissioner of Internal Revenue ("Commissioner") unconvincingly seeks to challenge express and well grounded findings of fact of the Tax Court, thereby impliedly conceding that such findings are inconsistent with the Tax Court's ultimate holding and support appellants' position. Commissioner also errs in

relying essentially on the doctrine that property received for services is ordinary income, when the issue before the Court is not whether receipt of stock for services performed is income, but rather whether or not Appellant Ivler's ("Ivler's") release in 1966 and 1967 of a right to acquire a capital asset, which right was obtained in 1963, qualifies for capital gains treatment. As shown below, the Commissioner's arguments should be rejected.

THE TAX COURT ERRED IN RULING THAT PAYMENT TO IVLER FOR HIS RELEASE OF RIGHTS TO ACQUIRE STOCK DID NOT QUALIFY FOR CAPITAL GAINS TREATMENT

The following issues were before the Tax Court:

1. What rights did Ivler obtain in 1963 when he joined Gevyn?

2. Were the payments made to Ivler in 1966 and 1967 intended to be payments for the sale or exchange of the rights received in 1963?

3. Did the rights received in 1963 constitute a capital asset and, if so, what was the value of such rights (a) upon their receipt by Ivler and (b) upon their release by Ivler?

(a) The Rights Obtained in 1963

With respect to the first of the above issues, the Tax Court expressly found that in 1963 when Ivler joined Gevyn

> "It was agreed that William's [Ivler's] salary be fixed at $30,000 annually and that he acquire one-third of the stock of Gevyn outstanding (App., page 15-a)."

Therefore, Commissioner's argument that Ivler did not acquire such rights in 1963 is in reality an attempt to overturn the trial court's explicit finding of fact that such rights were acquired at that time (Commissioner's brief, pp. 9-13). This finding is overwhelmingly supported by the record, for both Ivler and Evelyn Ungar, the only two trial witnesses, so testified (App., pp. 30-a to 35-a, 37-a to 38-a, 45-a to 47-a, 82-a to 87-a, 102-a to 104-a; see Exhibit 5-E, page 2; Exhibit 7-G; Exhibit 9-I, page 1). The Commissioner has totally failed to show that the Tax Court's findings which it challenges are "clearly erroneous" and thus its effort to overcome that finding must fail. E.g., Hughes v. Commissioner, 451 F.2d 975, 977, n.5 (2d Cir. 1971); Grace Bros., Inc. v. Commissioner, 173 F.2d 170, 173 (9th Cir. 1949).

(b) The Rights Received in 1963 Were Released In Return for the Payments Made in 1966 and 1967

The Tax Court correctly recognized that it was not conclusively bound by the characterization of the monetary payments to be made to Ivler in the November 30, 1965 contract as compensation for services and could look to the full record to see whether the proof was strong that the written statement did not reflect the actual agreement between the parties (App. 16-a). Since the Tax Court decision characterizes the $300,000 in cash paid to Ivler as "cash payments received in lieu" of Ivler's right to an equity interest, the Tax Court did indeed find that the $300,000 was paid for release of Ivler's right to an equity interest (App. 18-a). Indeed, it predicated its opinion on the assumption that Ivler gave up his rights (received in 1963) to an equity interest for cash in 1966 and 1967, but erroneously held that in such a situation the cash payments were nevertheless ordinary income because received for refraining from labor. (App. 17-a, 18-a).*

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* As shown below at page 8, the payments made in 1966 and 1967 were not ordinary income to Ivler regardless of whether the 1963 rights were obtained for refraining from labor.

(c) The Rights Received in 1963 Constituted a Capital Asset Which on a Subsequent Sale or Exchange Should Receive Capital Gains Treatment

Having found that Ivler acquired rights in 1963 to acquire stock in Gevyn at a later date, the Tax Court was required to determine whether or not such rights were capital assets which, upon a later sale or exchange, would receive capital gains treatment. Compelling authority holds that a contract right to acquire property (such as shares of stock) which would be a capital asset in the hands of the purchaser is itself a capital asset. E.g., Turzillo v. Commissioner, 346 F.2d 884 (6th Cir. 1965) (discussed in appellants' main brief, pp. 10-12); United States Freight Co. v. United States, 422 F.2d 887 (Ct. Cl. 1970). In United States Freight Co., taxpayer had agreed to purchase shares of stock and had deposited $500,000 to be treated as liquidated damages if it failed to make such purchase. Taxpayer failed to exercise its right and claimed the $500,000 as a loss against ordinary income. While the Court held in taxpayers favor, it recognized the principle

> "that a contract right to purchase what would be a capital asset in the purchaser's hands is itself a capital asset, to be not only reasonable, but also the subject of authoritative support. See, Commissioner of Internal Revenue v. Ferrer, 304 F.2d 125 (2d Cir. 1962). Id. at 892, n.3.

The Court further declared:

> ". . . the release for a sum by the buyer of his contract right to purchase certain property does constitute the sale or exchange of a capital asset. Thus, in the case before us, if the Pauls [the prospective sellers] had decided not to sell the subject stock and, instead, paid a sum to plaintiff for the release of his stock-purchase contract right, we would have essentially the Turzillo case and its capital treatment result." Id. at 893. (Emphasis added)

This Court has itself expressed approval of cases which have held that relinquishment of a right to acquire property would entitle the taxpayer to capital gains treatment:

> "One common characteristic of the group held to come within the capital gain provision is that the taxpayer had either what might be called an 'estate' in (Golonsky, McCue, Metropolitan), or an 'encumbrance' on (Ray), or an option to acquire an interest in (Dorman), property which, if itself held, would be a capital asset. In all these cases the taxpayer had something more than an opportunity afforded by contract, to obtain periodic receipts of income, by dealing with another (Starr, Leh, General Artists, Pittston), or by rendering services (Holt), or by virtue of ownership of a larger 'estate' (Hort, P.G. Lake)." Commissioner v. Ferrer, 304 F.2d 125, 130-31 (2d Cir. 1962).

In Commissioner v. Ferrer, supra, this Court held, inter alia, that taxpayer's receipt of payments for surrender of his lease of a play was a payment for the sale or exchange of a capital asset and stated:

> "We see no basis for holding that amounts paid Ferrer for surrender of his lease of the play are excluded from capital gain treatment because receipts from the play would have been ordinary income. The latter is equally true if a lessee of real property sells or surrenders a lease from which he is receiving business income or subrentals; yet Golonsky and McCue Bros. & Drummond held such to be the sale or exchange of a capital asset, as §1241 now provides." Id. at 132.

This Court specifically approved in Commissioner v. Ferrer the approach taken by the Ninth Circuit in Dorman v. United States, 296 F.2d 27 (9th Cir. 1961), a case which stressed that an executory contract entitling taxpayer to obtain an interest in the partnership which employed him was itself a capital asset the release of which would result in capital gains treatment:

> "But we cannot agree with the trial court that appellant's only status with respect to the partnership was that of an employee who was paid separation pay. Before the dissolution of the partnership, appellant [taxpayer] had in addition to his salaried position a contractual right to acquire an interest in the partnership and to receive a share of the partnership profits (Conclusion of Law No. 7, R. p. 31). In other words, he had an interest in an executory contract. In reality, it was this executory contract which Holmes [the other partner] bought from appellant for $12,470. And it is clear that an executory contract is a capital asset. (Levensen v. United States, N.D. Ala. 1957, 157 F.Supp. 244, 249; Commissioner v. Goff, 3 Cir. 1954, 212 F.2d 875, cert. denied, 348 U.S. 829, 75 S.Ct. 52, 99 L.Ed. 654.)" Id. at 29 (Emphasis added)

As shown above, the Trial Court correctly found that in 1963 Ivler acquired rights to obtain stock in Gevyn under an executory contract. However, in disregard of the principles embodied in the cases cited above, the Tax Court erroneously concluded that the monies paid for release of such rights in 1966 and 1967 was ordinary income. Even if as the Tax Court impliedly held, the rights received in 1963 constituted ordinary income to Ivler, the ordinary income involved would be the value of the rights received in 1963 -- not 1966 and 1967 -- and the subsequent sale of such rights in 1966 and 1967 would receive capital gains treatment. See, e.g., Beals' Estate v. Commissioner, 82 F.2d 268 (2d Cir. 1936) (rights received for agreement not to compete held ordinary income in year received).

Since the trial record conclusively shows that the rights received by Ivler in 1963 to obtain stock in Gevyn had a zero value, the full amount paid in 1966 and 1967 for release of such rights represented appreciation of the value of such rights and should be taxed as a capital gain. Ivler testified, and Evelyn Ungar confirmed, that in 1963 when Ivler acquired his rights to Gevyn stock, the parties agreed that Gevyn was worth $270,000 and the $270,000 would be

deducted from the value of the assets in which Ivler would receive his stock interest, thereby establishing the value of the rights that Ivler acquired at a zero base (App. pp. 32-a, 33-a, 112-a to 115-a). Commissioner offered no contradictory evidence at the trial. There should be no dispute that if, at the time the agreement was made in July 1963, the Ungars withdrew $270,000 from Gevyn (as they actually did in 1965 (Exhibit 8-H, p.1)) and the stock was issued to Ivler, Ivler's later relinquishment of the stock upon the payment to him of $300,000 would be given capital gains treatment. See, Commissioner v. Ferrer, supra, Dorman v. United States, supra, Turzillo v. Commissioner, supra, United States Freight Company v. United States, supra. The actual situation is indistinguishable for tax law purposes and should receive identical treatment.

The evidence submitted at trial also shows that in determining the amount to be paid Ivler in 1966 and 1967 for release of the rights Ivler received in 1963, Ivler and the Ungars did not proceed by valuing Ivler's services, but rather by determining the appreciated value of Gevyn in 1966. (App. 53-a, 54-a; Exhibit 9-I, pages 14-16; Exhibit 10(1)(2) and (3); Exhibit 11.) Such approach further supports

a conclusion that the 1966 and 1967 payments were not compensation for services or refraining from labor, but rather for release of a capital asset. See, E.g., Commissioner v. Ferrer, supra, 304 F.2d at 133, (lack of equivalence between amounts paid for surrender of a lease and income which would have been received by its retention supported capital gains treatment); Gordon v. Commissioner, 262 F.2d 413, 415 (5th Cir. 1958).

Commissioner attempts to distinguish Dorman v. United States, supra, and Turzillo v. Commissioner, supra, by arguing that in those cases the taxpayer had relinquished interests in business which "were the product of the taxpayers' investments." (Commissioner's brief, p.15). Such alleged factual distinction is both incorrect and irrelevant. In Turzillo, the "option contract" that formed the basis of taxpayer's claim for capital gains treatment involved a right to determine the disposition of Class A stock in the subject corporation, and such rights were awarded the taxpayer without the payment of any sum representing an "investment" in the option.* While in Dorman the taxpayer did

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* Taxpayer had paid $10,000 for Class B stock in the corporation, but such investment was not deemed consideration for taxpayers' rights with respect to Class A stock.

make a purported "capital contribution" to obtain the rights involved, the court's discussion reveals that the taxpayer's "capital contribution" was structured so that in reality he made no financial investment:

> "Appellant Dorman contributed no cash to the partnership. His 'capital contribution' of $300,000 was lent to him by. . . [his partner] and was evidenced by six promissory notes payable to. . . [the partner]. The notes were payable only out of appellant Dorman's share of the profits, and the partnership agreement provided that Dorman's interest in the assets of the partnership was not to be deemed . . . a fully paid vested interest until the promissory notes were paid off." 296 F.2d at 28.

Moreover, the tax code does not require a financial investment by taxpayer before the taxpayer can obtain capital gains treatment, but only that the taxpayer have engaged in the sale or exchange of a capital asset. Internal Revenue Code of 1954, §§1221, 1222.* Thus, in Dorman, the Court ignored the alleged "capital contribution" and stressed the specific nature of the right which taxpayer originally received and subsequently relinquished:

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* Commissioner's argument that capital gains treatment should be denied any gain from sale of a capital asset not obtained through a financial investment would deny capital gains treatment to gains received on sales of stock which were received as a gift -- a clearly incorrect result. E.g., Commissioner v. Turner, 410 F.2d 752, 753 (6th Cir. 1969).

> "Taxpayer had something more extensive than a mere employment contract. A right to acquire, in the future, 'a fully paid vested interest' is surely more akin to the situation where one has a capital interest, rather than to one where there is mere employment, where the employee has no right, present or future, to acquire such a capital interest. This right, or 'option,' to acquire a capital interest represents more than a possibility of receiving ordinary income in the future. It presents taxpayer a present opportunity to realize future capital gains, if any there be. And unlike Commissioner v. P. G. Lake, Inc., 1958, 356 U.S. 260, 78 S.Ct. 691, 2 L.Ed.2d 743, the $12,470 payment to taxpayer was in no respect 'present consideration received by the taxpayer for the right to receive future income,' but was paid in recognition of an already existing increase in the value of income producing property (either a partnership, ruled out by the district court, or a right to acquire an interest therein, as we here hold)." 296 F.2d at 29-30. (Emphasis in original).

Like the taxpayer in Dorman, in 1963 Ivler received "a present opportunity to realize future capital gains," and the cash paid to Ivler in 1966 and 1967 was paid "in recognition of an already existing increase in the value of income producing property" owned by Ivler -- i.e., his right (received in 1963) to acquire stock in Gevyn at a later date. 296 F.2d at 30.

The various cases cited by the Commissioner at pages 13 and 14 of his brief to support the argument that Ivler's right to acquire stock was "nothing more than another

form of compensation" are inapposite. Such cases do not involve situations where, as here and in Dorman and Turzillo, the taxpayer received monies for releasing existing rights to acquire a capital asset, but rather involve situations where capital assets were received as compensation for services. E.g., Commissioner v. Lo Bue, 351 U.S. 243 (1956) (gain resulting from employee's exercise of stock options was ordinary income); Champion v. Commissioner, 303 F.2d 887 (5th Cir. 1962) (gain resulting from receipt of stock issued as compensation and from exercise of stock option received as compensation was ordinary income); Commissioner v. Vandeveer, 114 F.2d 719 (6th Cir. 1940) (issue was cash value of stock paid to taxpayer in return for release of bonus claims); United States v. Frazell, 335 F.2d 487 (5th Cir. 1964), cert. denied, 380 U.S. 961 (1965) (value of stock issued for services held ordinary income). Other cases cited by the Commissioner are even further afield. E.g., Wolder v. Commissioner, 493 F.2d 608 (2d Cir.) cert. denied, 419 U.S. 828 (1974) (client's bequest to attorney pursuant to contract with attorney in return for attorney's services during client's lifetime held compensation to

attorney); Beal's Estate v. Commissioner, 82 F.2d 268 (2d Cir. 1936) (receipt of stock for agreement not to compete held taxable as ordinary income).

The Commissioner also errs in arguing on page 14 of his brief that Ivler's exchange of rights received in 1963 for cash in 1966 or 1967 would not qualify for capital gain taxation unless the rights received in 1963 had been included in Ivler's income. Thus, receipt of the capital assets involved in Commissioner v. Ferrer, supra, Dorman, supra, and Turzillo, supra, had not been reported as income, yet capital gains treatment was afforded release of such rights.* Again, the cases cited by the Commissioner on this point are inapposite because they do not deal with situations involving payment for release of a right to acquire a capital asset, but rather involve the situation in which amounts received were a direct substitute for payments which would have been ordinary income (e.g., Hort v. Commissioner, 313 U.S. 28 (1941) (amount received by lessor upon cancellation

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* Moreover, as shown above, Ivler's rights to acquire Gevyn stock had no value in 1963 and consequently did not constitute income.

of lease was ordinary income as substitute for rent); Shuster v. Helvering, 121 F.2d 643 (2d Cir. 1941) (payments to employee in lieu of payments under original employment contract); Gordon v. Commissioner, 262 F.2d 413 (5th Cir. 1958) (payments to employees in settlement of amounts owing under employment contract)) or were amounts received in direct payment for services (Roscoe v. Commissioner, 215 F.2d 478 (5th Cir. 1954).

CONCLUSION

For the reasons presented above and in appellants' main brief, the Court should reverse the July 21, 1976 Order of the Tax Court determining that deficiencies exist in appellants' federal income tax returns for 1966 and 1967.

Respectfully submitted,

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STATE OF NEW YORK)
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PATRICIA K. COLE, being duly sworn, deposes and says that she is in the employ of Milberg & Weiss, attorneys for the within named Plaintiffs-Appellants herein, and is over the age of 21 years. That on the 7th day of February, 1977, she served three copies of the within REPLY BRIEF FOR APPELLANTS upon the attorneys for the respective parties named below, by depositing same securely enclosed in post-paid wrapper in a post office box regularly maintained by the United States Government at One Pennsylvania Plaza, New York, New York, directed to each of them at their respective addresses set forth below, those being the addresses designated by them for that purpose on the preceding papers in this action, or the places where they then kept their respective offices between which places there then was and now is a regular communication by mail:

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Sworn to before me this

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Commission Expires March 30, 1977